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**Before the**
**FEDERAL COMMUNICATIONS COMMISSION**
**Washington, DC 20554**

JUN 1 1996

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| In the Matter of | ) | |
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| Allocation of Costs Associated with | ) | CC Docket No. 96-112 |
| Local Exchange Carrier Provision | ) | |
| of Video Programming Services | ) | |

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## REPLY COMMENTS OF THE AD HOC TELECOMMUNICATIONS USER COMMITTEE


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## SUMMARY

Part 64 of the Commission's Rules currently allocates excessive costs to ILEC regulated telecommunications services. If Part 64 is not properly changed, customers of the ILECs' basic telecommunications services will subsidize ILEC entry into the video services market, and possibly other unregulated markets.

If the Commission allows the ILECs to cross-subsidize their entry into the video services market, competition in the video services market will not be fair. Indeed, cross-subsidized ILEC entry into the video services market could adversely affect the financial ability of cable television operators to modify their plant to provide two-way telecommunications services. As a consequence, competition in the telecommunications and video services market would be adversely affected.

The ILECs' arguments that cost allocations are irrelevant under price caps regulation are simply wrong for several reasons. Ad Hoc has pending a petition for reconsideration of the Commission's decision to eliminate the sharing requirement for ILECs that choose to operate under a 5.3% "X" factor. Moreover, not all ILECs have chosen to operate under the 5.3% "X" factor. Some are subject to sharing obligations; those that currently are not could revert in the future to operation under a lower "X" factor, and thus, would be subject to a sharing obligation. As long as carrier earnings are constrained by the Commission's rules

or the Communications Act, cost allocations are highly relevant. Additionally, allocation to basic telecommunications services of LEC investment in plant that can be used for video services depresses the "X" factor, leads to inflated price cap indices and excessive access service rates. The Commission should not allow the ILECs to succeed in their efforts to obscure these effects.

AT&T and MCI provide sound approaches for Commission prescription of at least an interim fixed allocation factor to apply to ILEC common plant. The Commission should promptly adopt a fixed allocation factor of approximately 50%, and should reject ILEC arguments that would delay implementation of a fixed allocation factor

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## TABLE OF CONTENTS

| | | |
|---|---|---|
| SUMMARY | | i |
| I. | Introduction | 1 |
| II. | The Commission Should Reject the ILECs' Arguments Opposing The NPRM's Sound Cost Allocation Proposals | 4 |
| | A. ILEC Argument: Current Part 64 Rules Are Sufficient | 4 |
| | B. ILEC Argument: Cost Allocation Requirements Should Be Eliminated For Price Caps LECs | 6 |
| | C. ILEC Argument: The Commission Should Adopt A Flexible Approach To Cost Allocation That Does Not Mandate Uniform Or Prescribed Allocation Methods | 8 |
| | D. ILEC Argument: To The Extent Cost Allocations Are Prescribed, Allocation Factors Should Be Based On The Relative Number Of Subscribers Or Connections | 10 |
| III. | The Best Means Of Allocating Costs Between ILEC Regulated And Nonregulated Services Is Through Use Of A Fixed Factor Approach, In Combination With A Cost Ceiling Benchmark Based On The Forward-Looking Stand-Alone Costs Of Telephony | 11 |
| IV. | Ad Hoc Agrees With Parties Supporting The Reduction Of Price Cap Indices Through Exogenous Cost Changes To Reflect The Reallocation Of Costs To Nonregulated Activities | 13 |
| CONCLUSION | | 14 |

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**REPLY COMMENTS OF THE**
**AD HOC TELECOMMUNICATIONS USER COMMITTEE**

The Ad Hoc Telecommunications Committee ("Ad Hoc" or "Committee") hereby submits its reply to comments filed in response to the Commission's *Notice of Proposed Rulemaking* ("NPRM"), released May 10, 1996, in the above-captioned proceeding.

I. INTRODUCTION

The issues raised in the Commission's NPRM, particularly, the question of how to allocate common costs between (i) video services and other nonregulated offerings of the Incumbent Local Exchange Carriers (ILECs) and (ii) the regulated basic telecommunications services they already offer are matters of great concern to Committee members, who are among the nation's largest consumers of telecommunications services. Allocation of ILEC costs will directly affect the rates that Committee members pay for interstate services and indirectly affect those rates because the allocation of ILEC costs will impact the level of competition in the video services and traditional telephony markets.

In connection with various Video Dial Tone (VDT) related matters, Ad Hoc expressed concern that, under existing cost allocation rules, ILECs could inappropriately shift to customers of ILEC telephony services, particularly those services for which the ILECs face no consequential level of competition, costs ILECs incur in anticipation of entering the video services business.[1] The Committee explained that price cap regulation would not prevent cross-subsidization of VDT service by existing telephony services.[2] To address the problem of cross subsidization of VDT service in a price cap environment, Ad Hoc urged the Commission to unbundle the price cap productivity factor to ensure that alleged cost savings and scope economies would be flowed through to customers of ILEC telephony services rather than being diverted to support video entry.[3]

The Telecommunications Act of 1996 (the "1996 Act") eliminated the Commission's existing VDT rules and policies and established a new paradigm under which ILECs can enter and compete in the video programming services market, including the "open video system" ("OVS") model. However, Ad Hoc's concerns regarding proper allocation of costs to basic telephony versus competitive video services raised in the context of ILECs' proposed VDT services are equally applicable to OVS.

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1 *See, e.g.,* Ad Hoc Telecommunications Users ("Ad Hoc" or "the Committee") Petition to Deny Pacific Bell Section 214 Application, W-P-C 6913-16, February 14, 1994; Ad Hoc Petition to Deny Ameritech Section 214 Application, W-P-C 6926, March 11, 1994; Ad Hoc Initial and Reply Comments, In the Matter of Price Cap Performance Review for Local Exchange Carriers; Treatment of Video Dialtone Services Under Price Cap Regulation, CC Docket No. 94-1, April 17, 1995 and May 17, 1995, respectively; Ad Hoc Reply Comments in response to *Second Report and Order and Third Further Notice of Proposed Rulemaking*, CC Docket No. 94-1, November 20, 1995.

2 *See* Ad Hoc Initial Comments, CC Docket No. 94-1, *op cit*, at 4.

3 *Id.*, at 14.

The ILECs' comments, on the other hand, dismiss the concerns set forth in the NPRM. They oppose cost allocation requirements generally, and restate old positions and proposals advocated in the course of the VDT proceedings.
ILEC arguments warning of "regulatory overkill"[4] or seeking to convince the Commission that this docket is "unnecessary" or nothing more than a vehicle for the cable industry to misuse the federal regulatory process to thwart ILEC entry in video markets[5] are just plain wrong. To be sure, the telephone and cable industries are motivated by their own-self interest and strategic positioning as they seek to enter each other's markets. Clashing interests, however do not detract from, indeed they affirm, the necessity of devising reasonable and workable cost allocation rules to satisfy the Act's mandate that ILECs not use non-competitive services to subsidize entry into new markets, such as the video services market, and to ensure that telephone ratepayers be allowed to share in the benefits of scope economies inherent to the construction of hybrid systems.[6]

The Commission should look beyond telco-cable rhetoric and consider the proposals of parties, such as the California Public Utilities Commission, MCI, and AT&T, who present a more balanced perspective on these issues and generally support the tentative conclusions set forth in the NPRM The proposals submitted by these parties suggest allocating roughly 50% of the ILECs' common costs to video and other

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4 *See e.g.*, Comments of US West ("US West Comments"). at 4.

5 *See e.g.*, Comments of BellSouth ("BellSouthComments"), Summary, at iii.

6 As correctly recognized in the NPRM at para. 35, "if the provision of a hybrid system is an economically efficient business decision, it will include economies of scope," such that "the provision of telephony under the hybrid system, therefore, should be less costly than under the current stand-alone telephony system."

nonregulated services, and suggest imposing a ceiling on costs allocated to regulated telephony based on the forward-looking costs of providing telephony services.[7]

## II. THE COMMISSION SHOULD REJECT THE ILECS' ARGUMENTS OPPOSING THE NPRM'S SOUND COST ALLOCATION PROPOSALS.

The ILECs' comments in opposition to the Commission's tentative findings can be grouped into four main lines of argument

- Current Part 64 rules are sufficient;
- Cost allocation requirements should be eliminated for price cap LECs;
- The Commission should adopt a flexible approach to cost allocation that does not mandate specific allocation factors; and
- To the extent allocations of costs are prescribed, allocation factors should be based on the relative number of subscribers or connections.

The ILECs' arguments are without merit.

### A. ILEC Argument: Current Part 64 Rules Are Sufficient.

In almost mantra-like fashion, the ILECs argue there is no need for the Commission to revise Part 64 of its rules to account for hybrid systems. US West, for example, argues that current cost allocation manual approval and reporting processes, in combination with auditing requirements, are sufficient to ensure that regulated ratepayers do not cross-subsidize nonregulated services.[8] Ameritech goes so far as to feign surprise that "the Commission would say now that its cost allocation rules were

[7] *See*, Comments of the People of the State of California and the Public Utilities Commission of the State of California ("Cal. PUC Comments"), at 4, Comments of AT&T ("AT&T Comments"), at 4-7, Comments of MCI ("MCI Comments"), at 7

[8] US West Comments, at ii, 7.

not designed to separate the cost of regulated service from the cost of nonregulated service," citing the Commission's acceptance of Part 64 rules in the VDT proceedings.[9]

The NPRM clearly explains that the cornerstone of the current cost allocation process is the direct assignment of dedicated plant, with the assignment of relatively small amounts of common costs largely following the direct assignment.[10] This method makes no sense when ILECs build plant that is capable of transmitting basic telephony services and video services The common costs embedded in such hybrid systems will dwarf dedicated or directly-assigned plant. As a consequence, the current Part 64 methodology does not lend itself to meaningful application. As Time Warner so colorfully expresses it:

> In the likely event that common costs of loops and interoffice trunks come to predominate over directly assigned stand-alone costs of such facilities, one would end up with relatively minor (and easily manipulated) cost elements dictating the allocation of the major cost elements; in other words, the directly-assigned tail would end up wagging the common cost dog.[11]

Furthermore, ILEC attempts to hold the Commission to cost allocation findings made in the course of past VDT proceedings have no substantive value. The VDT process was truly a learning experience, and it is obvious from the substance of this NPRM that the Commission has learned a great deal from information and cost allocation proposals submitted by the ILECs in the VDT proceedings. Administrative agencies, of course, can change positions and policies; they need only provide a

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[9] Comments of Ameritech ("Ameritech Comments"), at 17. Sprint similarly cites to an old video dialtone decision in which the Commission rejects claims to amend Part 64 rules. Comments of Sprint ("Sprint Comments"), at 3.

[10] NPRM, para. 18-19.

[11] Comments of Time Warner ("Time Warner Comments"), at 6-7.

reasoned basis for such changes. Moreover, there now is a greater urgency for the Commission to resolve the difficult cost allocation issues left open in the VDT proceedings. The passage of the 1996 Telecommunications Act mandates both the accelerated opening of telecommunications markets to competition and assurance that telephone ratepayers do not bear the costs and risks of the ILECs' competitive, nonregulated activities.[12] The NPRM is responsive to these legislative requirements.

B. ILEC Argument: Cost Allocation Requirements Should Be Eliminated For Price Cap LECs.

Although retention of current Part 64 cost allocation rules would provide ILECs ample opportunity to subsidize entry into the video services market, some ILECs go even further: they argue for outright elimination of cost allocation requirements for price cap LECs. BellSouth suggests that elimination of cost allocation requirements would "give this docket purpose" and scolds the Commission for its lack of "faith in the procompetitive forces that Congress has unleashed."[13] NYNEX, Ameritech, and Pacific concur that the Commission should waive the Part 64 rules where a LEC is governed by FCC price cap regulation with no sharing/low-end adjustment.[14]

Assertions that current levels of competition in the access and local exchange services market eliminates the need for strong cost allocation rules is simply wrong. The ILECs do not at this time face effective competition. The competition that they confront is limited, niche competition. In the absence of cost allocation rules

[12] NPRM, para. 22.

[13] BellSouth Comments, at iv-v. Pacific similarly argues [at iii] that "[c]ompetition entirely eliminates the need for cost allocation requirements."

[14] Comments of NYNEX ("NYNEX Comments"), at i, Ameritech Comments, at 2; Pacific Comments, at iii.

explicitly designed to apply to hybrid systems, the ILECs will have both the incentive and the opportunity to load the costs of hybrid system onto regulated services, even under price cap regulation.

It also simply is not true that rates under price cap regulation are unaffected by cost allocation rules. As discussed by Ad Hoc in its Comments submitted in CC Docket 94-1 concerning the creation of a separate VDT basket, cost allocations affect the productivity factor which in turn directly affects the rates set under a price cap regime.[15] ILEC replacement of existing plant with new hybrid facilities capable of supporting future broadband and video services depresses the *apparent* productivity growth rate exhibited by these companies, because (a) the rate of growth of LEC capital inputs is greater than it would otherwise be absent these competitive-driven investment programs, and (b) the remaining lives of embedded voice/narrowband facilities is shortened by an accelerated rate of plant replacement and retirement, producing higher economic and accounting depreciation rates than would prevail absent the competitively-driven replacement initiatives.[16]

On this basis, Ad Hoc argued in CC Docket No. 94-1 that the productivity factor should be unbundled as between regulated telephony services (for which a productivity factor higher than the composite can be attributed) and regulated video services (for which a productivity factor lower than the composite can be attributed), in order to assure that any cost improvements (i.e. scope economies) attributed by the ILECs to the deployment of hybrid systems are actually flowed through to regulated rates. While ILEC video services provided under OVS would be offered on a non-

15 *See*, Ad Hoc Initial Comments, at 11-16.

16 *Id.*

regulated basis, such that an actual unbundling of the X-Factor as between voice and video services is no longer applicable, the equivalent outcome can (and should) be achieved through the reduction of related price cap indices through exogenous changes, as tentatively recommended in the NPRM.

Cost allocation also affects the determination of whether earnings trigger a sharing obligation. Since ILECs have the ability to switch annually among sharing and no-sharing price cap options, an ILEC's selection of a no-sharing option in any given year does not, as several of the ILECs assert, sever all links between costs and regulated rates. As Cox notes:

> Even if a LEC elects a no-sharing option, it still has an incentive to systematically misallocate costs to regulated services, thereby reducing regulated earnings and avoiding future sharing obligations... as long as any regulator reviews an incumbent LEC's cost information for any purpose (e.g., universal service) the allocation of cost between regulated and nonregulated services remains an important issue.[17]

Furthermore, Ad Hoc has challenged in a still pending petition for reconsideration the legality of eliminating the sharing requirement.[18] Whether the ILECs like it or not, the just and reasonable standard applies to their regulated services rates and the lawfulness of those rates is affected by ILEC earnings. As a matter of law, cost allocations between regulated and unregulated services are mandatory.

### C. ILEC Argument: The Commission Should Adopt A Flexible Approach To Cost Allocation That Does Not Mandate Uniform Or Prescribed Allocation Methods.

[17] Comments of Cox Communications, Inc., ("Cox Comments") at 11-12.

[18] Ad Hoc, Petition for Expedited Partial Reconsideration of First Report and Order, CC Docket No. 94-1, filed May 19, 1995

Most of the ILECs solidly reject the Commission's tentative conclusion to use a specific fixed factor or prescribed uniform allocation method to allocate plant costs between regulated and nonregulated activities. Instead, the ILECs argue in favor of a "flexible" or "case-by-case" approach to cost allocation, that would allow each ILEC to tailor allocation methods according to its own individual conditions.[19] ILEC arguments in favor of a "flexible approach," however, are thinly-veiled variations on the "no cost allocation requirement" position discussed above. Under the flexible approach, ILECs would be left to their own devices similar to what occurred in the VDT proceeding. As evidenced by the cost allocation approaches proposed by the ILECs in the VDT proceeding, the "flexible approach" is conducive to gaming and will most assuredly lead to cost allocation schemes which under-allocate costs to competitive video ventures of the ILECs and over-allocate costs to regulated telephony services.[20] Overall, there are likely to be far more similarities than differences for the ILECs who choose to enter the video programming market under the OVS option, so that arguments that uniform cost allocations approaches won't work because of differences among ILECs and the effects of rapidly changing technology[21] are not persuasive and are outweighed by the need for administratively simple and effective cost allocation.

Moreover, contrary to what the ILECs suggest, a uniform prescribed cost allocation approach can also be flexible and readily adaptable to changes in technology in that the specific percentages or benchmark cost ceilings can be changed from time

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[19] *See* US West Comments, at 14; BellSouth Comments, at vi; NYNEX Comments at 11; Ameritech Comments at 19; Pacific Comments, at 8; and Comments of GTE ("GTE Comments") at ii.

[20] *See*, Ad Hoc Petition to Deny Pacific Bell Section 214 Application, W-P-C 6913-16, February 14, 1994 at 5-11; Ad Hoc Petition to Deny Ameritech Section 214 Application, W-P-C 6926, March 11, 1994, at 11-14.

[21] *See, e.g.*, BellSouth Comments, at vi.

to time as conditions warrant, and as both the Commission and the industry gain experience with hybrid systems.[22] Allowing the fixed factor or cost ceiling benchmark to change over time is a much more reasonable solution to the problem of a lack of experience than a "free-for-all" allocation approach such as recommended by the ILECs.

D. ILEC Argument: To The Extent Cost Allocations Are Prescribed, Allocation Factors Should Be Based On The Relative Number Of Subscribers Or Connections.

Not all ILECs categorically reject the notion of a fixed factor or uniform prescribed allocation method. However, those few recommending specific allocation approaches argue in support of the very same types of cost allocation approaches ILECs proposed for VDT service. For example US West recommends a 50%/50% split of common costs on a per subscriber basis.[23]

Contrary to the impression US West would give, the results of US West's 50/50 allocator would be far different from the Commission's proposed 50/50 fixed factor approach, except in the unlikely event that the ILECs' hybrid system served an equal number of telephone and video subscribers For the foreseeable future, ILECs will likely be serving a far greater number of telephone subscribers than video service customers. US West's approach would result in the absolute dollar amount of hybrid system investment assigned to telephony far exceeding that assigned to video. Proposals by NYNEX (to allocate common costs in proportion to the relative number of

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[22] *See* Comments of NCTA ("NCTA Comments"), at 11-12, recommending that the "actual percentages used to split costs. may need to be revisited over time as technology, consumer demand, and policy goals evolve."

[23] US West Comments, at 11

telephony and video service connections),[24] and Puerto Rico Telephone Company (to allocate costs on the basis of relative revenue generated by the regulated versus the nonregulated activities)[25] would similarly result in a gross over-allocation of costs to regulated telephony services, particularly in the early years when ILECs' strategic need (and ability) to cross-subsidize video services by telephony is at its greatest.

## III. THE BEST MEANS OF ALLOCATING COSTS BETWEEN ILEC REGULATED AND NONREGULATED SERVICES IS THROUGH USE OF A FIXED FACTOR APPROACH, IN COMBINATION WITH A COST CEILING BENCHMARK BASED ON THE FORWARD-LOOKING STAND-ALONE COSTS OF TELEPHONY.

With the exception of the ILECs, the parties submitting comments generally endorse the Commission's tentative conclusions that: uniform, prescribed cost allocation rules are necessary; current Part 64 cost allocation rules must be revised; and use of either a fixed factor approach, a cost ceiling approach, or some combination of the two is appropriate for allocating costs between regulated telephony and nonregulated video services. Fixed-factor proposals presented by the parties range from the 50%/50% split between regulated and nonregulated activities highlighted in the NPRM (e.g., CPUC, GCI)[26] upwards to 70-75% of hybrid systems costs allocated to nonregulated activities (e.g., NCTA, Time Warner Comcast, Cox, California Cable Television Association).[27] Both MCI and AT&T propose the establishment of a fixed factor based upon relationships between stand alone telephone costs, as determined in Hatfield TSLRIC studies, and either total costs identified in Part 32 accounts, or TSLRIC

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[24] NYNEX Comments, at 11

[25] Comments of Puerto Rico Telephone Company, at ii.

[26] *See,* Cal. PUC Comments, at 2, Comments of General Communications, Inc., at 4.

[27] *See,* NCTA Comments, at 15, Comments of Time Warner, at 10, Comments of Comcast, at 4, Cox Comments, at 8, and Comments of California Cable Television Association, at 17

cost for video-capable loop plant, respectively.[28] NCTA also endorses reliance on the costs of a stand-alone (state-of-the-art) telephony system as a cost ceiling for costs allocated on the basis of the chosen fixed factor [29]

Ad Hoc strongly endorses the concept of a fixed factor approach *in combination with* a cost ceiling benchmark based upon the stand alone forward-looking costs of providing telephony services only. Taken together, these approaches provide the best, most workable means to protect against the cross-subsidization of ILEC video ventures and to ensure that telephone ratepayers share appropriately in the benefits of scope economies. The fixed factor approach alone, provided the percentage allocated to nonregulated activities is set high enough (e.g., of the order of magnitude proposed by the cable parties), would protect against the cross-subsidization of ILEC video ventures by telephone subscribers. However, there is some merit to the ILECs' argument that use of too high a fixed factor might go so far as to stifle the development of competitive alternatives in both video and telephony markets.[30] While the ILECs use this point to argue (incorrectly) for the elimination of effective cost allocation requirements, the more reasonable check against the setting of too high a fixed factor is to establish a benchmark for that fixed factor linked to data on the forward-looking stand alone costs of providing telephony services. In linking the fixed factor to a forward-looking stand-alone cost benchmark, the Commission can ensure that telephone subscribers receive an appropriate, but not excessive, share of the benefits of scope economies. The NPRM is right on point in expressing the belief "that Congress did not

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[28] *See,* MCI Comments. at 7-10, AT&T Comments at 4-6

[29] *See,* NCTA Comments, at 19.

[30] *See,* e.g., US West Comments at 9-10.

intend that telephone exchange service or exchange access subscribers pay rates designed to recover the costs of spare capacity that eventually will be used for video programming and other services that may be competitive."[31] To the extent spare capacity is predominantly motivated by the need to support nonregulated services, there is no justification for placing any significant portion of such investment in regulated accounts.[32] Accordingly, Ad Hoc agrees with the position of NCTA, MCI, and others that the costs of spare facilities should be assumed for and attributed to non-telephone purposes unless the ILEC can conclusively demonstrate the necessity of such facilities for the provision of telephony services, and that price cap indices be reduced to reflect the appropriate allocation of those costs to nonregulated services.[33]

## IV. AD HOC AGREES WITH PARTIES SUPPORTING THE REDUCTION OF PRICE CAP INDICES THROUGH EXOGENOUS COST CHANGES TO REFLECT THE REALLOCATION OF COSTS TO NONREGULATED ACTIVITIES.

Reallocations of costs from regulated to nonregulated activities should trigger decreases in related price cap indices through exogenous changes. The ILEC argument that downward exogenous changes associated with cost reallocations would undercut ILECs' incentive to construct hybrid systems that would otherwise benefit the telephone ratepayer is an empty threat. Unless there is an explicit mechanism, such as

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[31] Evidence presented in Docket 96-98 confirms that the ILECs have substantial excess capacity in loop and switching plant that cannot be explained by growth in basic service demand, but rather the ILECs desire to strategically position themselves in video and other broadband markets. *See* Lee L. Selwyn and Patricia D. Kravtin Analysis of Incumbent LEC Embedded Investment: An Empirical Perspective on the "Gap" between Historic Costs and Forward-looking TSLRIC, submitted with Reply Comments of AT&T, CC Docket 96-98, May 30, 1996

[32] *See,* NCTA Comments, at 21-22, MCI Comments at 15. As noted by MCI: "Now that the ILECs stand poised to enter the interexchange and video markets, it is imperative that the Commission immediately remove spare capacity from regulated accounts, and reimburse telephone customers for the amount of nonregulated spare capacity for which they have already paid."

[33] *See* NYNEX Comments, at 24; BellSouth Comments, at 15-16.

through an exogenous cost change adjustment, by which telephone subscribers would receive benefits of possible scope economies associated with a hybrid system, telephone subscribers as such would receive no benefit from ILEC construction of hybrid systems.

Moreover, as discussed previously, construction of excess capacity or replacement of existing plant with new hybrid facilities *not* required for regulated telephone services, has a depressing effect on historic ILEC total factor productivity that must be offset if one accepts the fundamental proposition that telephone ratepayers should share in the benefits of any scope economies to be realized from the construction of hybrid systems. The exogenous change component of the price cap formula is the correct means by which to make this offsetting adjustment.[34]

## CONCLUSION

For the above-stated reasons, Ad Hoc urges the Commission to adopt cost allocation and other regulatory mechanisms that are consistent with the views expressed in these reply comments.

Respectfully submitted,

Ad Hoc Telecommunications User Committee

By ______________________

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[34] *See*, e.g., NYNEX Comments, at 22-23, BellSouth Comments, at 14, Pacific Comments, at 17-18.

## Certificate of Service

I, Andrew Baer, hereby certify that true and correct copies of the preceding Reply Comments of the Ad Hoc Telecommunications Users Committee in the Matter of Allocation of Cost Associated with Local Exchange Carrier Provision of Video Programming Services, CC Docket No. 96-112, were served this 12th day of June, 1996, via first class mail, upon the parties on the attached service list, and via hand delivery of the following:

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